Oil inventories will eventually run low

The “I told you so” comments seem to be increasing with each day of bearish sentiment for oil that passes. As it drags on, opinions on the path that crude oil prices will take grow ever more divergent. Understanding what’s happening is not easy. The global supply of crude oil is complex with many moving parts in the supply chain.

Unfortunately, conventional wisdom does not always work as it should. The assumption that lower oil supply leads to an immediate draw on inventories is weak. You need to factor in oil in transit (i.e. tankers or pipelines), oil not officially classified as inventory (i.e. floating storage), and lastly total product inventories (i.e. gasoline, heating oil etc.).

However, the basic economic concepts of supply and demand do apply. High supply and constant demand equals a surplus, low supply and constant demand equals a deficit. Throw in several years of excess supply and you have a lot of total crude oil and petroleum product inventory.

For the sake of clarity, perhaps it’s best to think of it in terms of your own personal finances. Most of us have a current account that our salaries are paid into, which we use to finance our everyday consumption. And, most of us (hopefully) have a savings account to save a little for those unforeseen rainy days.

Now let’s say your current account is like the supply and demand of oil. Money goes in – the supply of oil. And money goes out – the demand for oil. If you manage your finances well, you can save a bit and put a little away in your savings account for those times in the future when you might face some financial hardship.

It’s the same in the oil industry, which is why when there is a supply glut of oil – that also leads to a supply glut of petroleum products – total inventories build up. When this surplus dries up, however, you have to draw down your inventories, just as you would simply dig into your savings if you need some extra cash.
This is what our global economy is doing right now. Since OPEC announced production cuts in November 2016, it's been digging into its savings by running down these oil inventories. However, the decline in petroleum product inventories is a positive leading indicator and though these effects will not be seen immediately, the process of rebalancing is underway.

The longer this persists and global demand erodes away these inventories, the greater the risk of a spike in crude oil prices.

To understand what will be needed to support higher crude oil prices, let's take a closer look at crude oil's current and savings accounts.

**Oil’s “current account” – current supply and demand**

<table>
<thead>
<tr>
<th>Supply</th>
<th>Demand</th>
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<tbody>
<tr>
<td>97.3 million barrels a day</td>
<td>98.1 million barrel per day</td>
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<tr>
<td>35.5 billion barrels a year</td>
<td>35.8 billion barrel a year</td>
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The imbalance creates a deficit of roughly 292 million barrels that will need to come from inventories (the savings account).

*Note: The estimate for demand is based on factors that point to year-on-year growth of 1.7 million barrels per day. This is higher than the long-term average of 1.3 million barrels, but the figure is more realistic based on current forecasts. The estimate for global crude supply takes into consideration the signalled production cuts from OPEC and non-OPEC.*

*Source: Vontobel Asset Management. Data as of 21 April, 2017*

As can be seen, demand will outpace supply by roughly 292 million barrels creating a market deficit already this year.

**Oil’s “savings account” – inventories**

Taking into account both OECD and non-OCED crude oil inventories, the figure stands at roughly 303 million barrels. The real bugbear remains with US inventories that makes up 69 percent of the total, or roughly 212 million barrels. Also, US inventories have continued to increase, up roughly 50 million barrels since the start of this year. However, this masks a 21-million-barrel decline so far this year in product inventories, which is counter-cyclical (it happened before the start of the US driving season).
What the two graphics above show is that the expected supply deficit for this year of around 292 million barrels will be funded from the excess inventory of 303 million barrels.

It's fair to say since OPEC's cut in November last year, global rebalancing has gotten off to a bad start dashing investor expectations and leading to increased bearish sentiment towards commodities. It has also meant that the expected shifts from contango to backwardation has been delayed.

However, the fact that oil prices have remained capped will very likely support cohesion within key OPEC players and a desire by Russia to remain supportive to extending supply cuts into the second half of 2017. How a final deal will look is currently anyone's guess.

Though mindful of the risks, we have a strategic investment bias to crude oil. Strategically, we favour Brent over WTI as we expect Brent to shift more quickly to backwardation. However, WTI could offer some tactical opportunities into the summer, ahead of the boost in seasonal gasoline demand. Despite a bad start to the rebalancing process, oil inventories will eventually run lower, creating tighter global oil markets and upside to oil prices.

It would be wise now to start actively managing your portfolio ahead of this impending rotation. Eventually, oil inventories will run low.

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